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# Securities Law Fifth Circuit Symposium

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## SECURITIES LAW

*Steven S. Thel\**

The Fifth Circuit decided some important securities cases during the survey period and issued some interesting opinions. Although the court consistently claimed a conservative reliance on precedent and seldom acknowledged making new law, it interpreted some well-established doctrine in surprising ways. The past year's opinions in fraud cases provide guidance in the related areas of reliance, damages, and plaintiff's due diligence. The year also witnessed important developments in the law governing the relationship between brokerage firms and their clients.

The most spectacular development in this area during the survey year was the October collapse in security prices. In light of the crash and increasing volatility in the securities markets, many have come to question the nature of the relationship between the price of securities and their value. In the spirit of the times, this survey starts with two opinions dealing with the relationship between price and value.

### RELIANCE AND DAMAGES

"[R]eliance is an issue in *all* Rule 10b-5 cases."<sup>1</sup> Traders often have difficulty proving that they were in fact influenced by misrepresentations they actually heard, and it is obviously difficult for traders to prove they relied on misrepresentations they never heard. The so-called fraud-on-the-market theory provides that security traders should sometimes be presumed to have relied on misrepresentations. A presumption that traders have relied can significantly change the way fraud cases are handled—particularly by facilitating the use of class actions<sup>2</sup>—and the way they are

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1. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 548 (5th Cir. Unit A 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983).

2. Many investors may be injured by one misrepresentation. A class action to rectify a misrepresentation may be impractical if each injured investor must prove she changed her position in reliance. If reliance is presumed, all questions except damages will usually be

decided.

In 1981, the Fifth Circuit, sitting en banc, accepted a form of presumptive reliance in *Shores v. Sklar*.<sup>3</sup> However, the plaintiff in that case alleged extreme misconduct, and the opinion seemed to allow the presumption only in extreme cases. Early in the survey year the Fifth Circuit revisited the doctrine of presumptive reliance in *Finkel v. Docutel/Olivetti Corp.*<sup>4</sup> The *Finkel* court's interpretation of *Shores* expanded the scope of the doctrine substantially beyond the limits *Shores* was sometimes thought to have set. Later in the survey year, the question was further complicated when the Supreme Court accepted the fraud-on-the-market theory in *Basic Inc. v. Levinson*.<sup>5</sup> The analytical framework set out in *Finkel* is more complicated than that used by the Supreme Court in *Basic*, primarily because the circuit court had to work around *Shores*. In the future, the court will have to decide how much of *Shores* and *Finkel* survives *Basic*.

*Finkel* was a class action brought on behalf of all those who purchased stock of Docutel/Olivetti Corporation during a period in which Docutel had publicly overstated the value of its inventories.<sup>6</sup> The plaintiff alleged that Docutel purchased inventory from a related company at inflated prices, but concealed this fact until it was forced to take substantial write-downs in connection with its year-end audit. She charged that in so doing, Docutel and certain of its affiliates had violated rule 10b-5.<sup>7</sup> According to the court of appeals, the thrust of her complaint was that "the delay in taking the write-downs defrauded purchasers of Docutel stock who bought it [during the period that the value of the inventory was overstated] by causing them to buy the stock at an inflated price."<sup>8</sup> Without ever certifying the class, the district court dismissed the complaint because the plaintiff failed to plead individual reliance. The court of appeals reversed, explaining that the district court

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common, and once a measure of damages is chosen, the calculation of individual awards will seldom require separate trials. Even if defendants are entitled to rebut the presumption by showing that some investors did not in fact rely, it is unlikely that they will be able to do so or that their attempts will make a class action inappropriate.

3. 647 F.2d 462 (5th Cir. 1981) (en banc), cert. denied, 459 U.S. 1102 (1983).

4. 817 F.2d 356 (5th Cir. 1987), cert. denied, 108 S. Ct. 1220 (1988).

5. 108 S. Ct. 978 (1988).

6. 817 F.2d at 358. The district court dismissed the complaint before it decided whether to certify the class.

7. *Id.* at 357-58 (citing 17 C.F.R. § 240.10b-5).

8. *Id.* at 358.

had not appreciated the full scope of *Shores*.<sup>9</sup>

*Shores* has to be the starting point of any discussion of the fraud-on-the-market theory in the Fifth Circuit. The plaintiff in *Shores* alleged that the defendants sold worthless revenue bonds by means of an elaborate fraudulent scheme.<sup>10</sup> Although the plaintiff alleged that the offering circular for the bonds contained numerous falsehoods, he admitted that he bought the bonds on his broker's recommendation and had never read the circular.<sup>11</sup> The entire court of appeals agreed that the district court correctly dismissed the complaint to the extent the plaintiff had pleaded "the usual" misrepresentation or omission case under the second clause of rule 10b-5, which declares false statements and half-truths illegal.<sup>12</sup> The court held that reliance was an essential element of such a case and that the plaintiff's admission that he had not relied on the circular was conclusive on the issue.<sup>13</sup>

The *Shores* complaint, however, tracked all three clauses of rule 10b-5, and a majority of the court, over a vigorous dissent, concluded that even though the plaintiff had not alleged reliance on the offering circular, he might recover under the first clause, which declares it unlawful to employ any scheme to defraud, and the third clause, which forbids engaging in any practice that operates as a fraud.<sup>14</sup> The majority held that the plaintiff's confidence in the integrity of the municipal authorities who authorized the bonds and his reliance on the availability of the bonds as an indication that they were entitled to be marketed would be reliance enough if the bonds would not have been marketable at any price absent the scheme.<sup>15</sup>

The complaint in *Finkel* also tracked the language of all three subparts of rule 10b-5. The court of appeals affirmed the district court's dismissal as to claims made under the second clause of the rule based on the plaintiff's failure to allege that she had read or had relied on any of the documents in which she claimed Docutel's financial situation was misrepresented.<sup>16</sup> However, the court re-

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9. *Id.*

10. 647 F.2d at 464.

11. *Id.*

12. *Id.* at 467-68.

13. *Id.*

14. *Id.* at 469 (citing 17 C.F.R. § 240.10b-5).

15. 647 F.2d at 470.

16. 817 F.2d at 363.

versed the dismissal of the claims under the first and third clauses. The court held that although reliance is a cornerstone of any claim under rule 10b-5, it will be presumed when the defendants have engaged in secret, pervasive, and material misconduct.<sup>17</sup> The defendants will then have the burden of rebutting the presumption of reliance by showing either that the nondisclosure of their conduct did not affect market price or that the plaintiff actually knew the undisclosed information or would have purchased the security at the same price even if she had known.<sup>18</sup>

*Finkel* went a long way toward making the Fifth Circuit fraud-on-the-market doctrine intelligible, but now that the Supreme Court has entered the field in *Basic*, the question is whether *Shores* and *Finkel* are still good law. The key to a fraud-on-the-market claim under *Shores* and *Finkel* is making out a claim under the first or third clauses of rule 10b-5, that is, alleging a scheme to defraud or a course of business operating as a fraud. Exactly what allegations will satisfy this test is unclear. It is not enough that the defendants have misrepresented material facts—the plaintiff must allege something that can be characterized as “fraud on a broader scale.”<sup>19</sup> More importantly, the scheme must be “primarily one of nondisclosure,” although the incidental making of material misrepresentations will not be fatal.<sup>20</sup>

In *Basic*, the Supreme Court overruled *Shores* and *Finkel* to the extent they held that the fraud-on-the-market presumption is appropriate only when plaintiffs complain of nondisclosure of pervasive fraudulent schemes.<sup>21</sup> *Basic* was a class action brought on behalf of persons who sold stock in a period during which the issuer falsely denied it was involved in merger negotiations. The Supreme Court held that when misleading statements of material fact “have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed.”<sup>22</sup> The Court did not treat the complaint as alleging a pervasive fraudulent scheme, and it noted incidentally that the relevant part of rule 10b-5 was the

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17. *Id.* at 364.

18. *Id.* at 364-65. The plaintiff need not show that the security to which the scheme relates is traded in a well-developed market, but if it is not, the defendant will presumably be able to show that the failure to disclose had no effect on price. *See id.* at 361 n.12, 362.

19. *Id.* at 362 (quoting *Shores*, 647 F.2d at 472).

20. *Id.* at 363.

21. 108 S. Ct. at 994.

22. *Id.* at 991.

second clause.<sup>23</sup>

Although the Supreme Court has ruled that the fraud-on-the-market presumption is appropriate in the "usual" misrepresentation case under rule 10b-5, the presumption's reach may extend to the unusual case as well under the Fifth Circuit decisions. *Shores* has sometimes been interpreted to hold that plaintiffs are entitled to the presumption of reliance only if they can prove that the securities they bought would not have been marketable at any price but for the fraudulent scheme. *Finkel* firmly rejected any such limitation and, in so doing, highlighted the continued importance of *Shores*. *Finkel* explained that *Shores* focused on marketability, not because it adopted a limited presumption of reliance, but because the revenue bonds involved in that case were not traded in an active market. Reliance is an aspect of causation. In the usual case, a plaintiff must show that a misrepresentation caused her injury by showing that she relied on the misrepresentation to her detriment. Prices on developed markets reflect all available information, including false statements, so a misrepresentation conveyed to a developed market can cause injury to those who participate in the market even if they do not hear it. The premise of the fraud-on-the-market theory is that investors should be entitled to rely on the integrity of the market. Perhaps, as *Finkel* puts it, the market is the "theoretical agent" of the investor,<sup>24</sup> and when a security is actively traded, the important question is not whether the investor relied on the misrepresentation, but whether the market did. Be that as it may, the theory justifies a presumption, if at all, only with respect to securities trading in a well-developed market.

When, as in *Shores*, price is not set by market forces, an investor must claim more than merely that she relied on the integrity of prices set by the market. *Shores* protected reliance on the availability of a security as evidence that it was entitled to be sold. The way the court explained it in *Finkel*, *Shores* did not adopt a restrictive version of the fraud-on-the-market theory in which reliance is to be presumed only when fraud makes it possible to market otherwise unmarketable securities.<sup>25</sup> Instead, *Shores* expansively interpreted the theory to encompass these cases, and in so doing permitted a presumption of reliance in cases in which

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23. See *id.* at 983 n.6.

24. 817 F.2d at 360.

25. *Id.* at 358.

no market exists at all.<sup>26</sup>

If the court affirmed its solicitude for buyers in *Finkel*, it showed that solicitude has its limits in *James v. Nico Energy Corp.*<sup>27</sup> The plaintiff in that case realized a gain of about 500% on his investment in oil wells promoted by the defendants.<sup>28</sup> His good fortune may have obscured the merits of his rule 10b-5 claim and may have led the court to restate its standard measure of damages in a way that will exonerate perpetrators of fraud who sell securities that ultimately appreciate in value. Perhaps more importantly, the court did not take advantage of a particularly good opportunity to reconsider its standard measure of damages.

Nico Energy Corporation was formed to exploit oil leases on three tracts of land.<sup>29</sup> Shortly after it was formed, Nico decided to drill an exploratory well on an eighty-acre well site on one of the tracts. The well site was located within a 711-acre portion of the tract that was outside a flood plain.<sup>30</sup> Nico raised funds for the exploratory well from a small group of investors. Investors in the exploratory well did not acquire any interest in the leases beyond their interest in the well site, but the cover letter for the private placement memorandum said that they would each have the option to participate in subsequent wells "on an additional 700 acres (approximately) to be designated by Nico from acreage it presently has under lease."<sup>31</sup> Quincy James bought into the deal.

The exploratory well was successful, and during the next two years Nico drilled ten more successful wells in the 711-acre area

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26. The Fifth Circuit followed the lead of the Eleventh Circuit in concluding that *Shores* did not restrict the presumption of reliance to cases in which fraud makes possible the sale of otherwise unmarketable securities. *Shores* was decided before the Fifth Circuit was split, and thus, it is binding in the Eleventh Circuit as well as in the Fifth. In *Lipton v. Documentation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985), the Eleventh Circuit explained that in *Shores* the court adopted a theory of fraud on the undeveloped market, but had no reason to adopt a theory of fraud on the open market. 734 F.2d at 745. The court went on to adopt the open-market theory in *Lipton*, finding it implicitly approved in *Shores*. *Id.* at 747; *see also* *Shores v. Sklar*, 844 F.2d 1485 (11th Cir. 1988). In *Lipton*, 734 F.2d at 746-47, the Eleventh Circuit held that the developed market's reliance on specific misrepresentations permits a presumption of individual reliance in actions under the second clause of rule 10b-5, but the Fifth Circuit refused to go so far in *Finkel*.

27. 838 F.2d 1365 (5th Cir. 1988).

28. *Id.* at 1367.

29. *Id.* at 1366-67.

30. *Id.* at 1367.

31. *Id.* An investor would have the option only so long as he participated in all prospects offered him. *Id.*

outside the flood plain.<sup>32</sup> James invested in five of the additional wells, but Nico did not give him an opportunity to participate in the other five, which it drilled with its own funds. James also participated in another well drilled by an oil company that bought Nico's interest in the tract. James invested a total of \$317,000 in seven wells and received in return more than \$1,866,000.<sup>33</sup> Nonetheless, he sued for part of the profits from the five wells Nico drilled with its own funds.<sup>34</sup>

James presented a number of theories of recovery, all related to the option set out in the cover letter for the private placement materials. Among other things, he claimed that he had a contractual right to participate in the five non-investor wells and that he had been defrauded within the meaning of the federal and Texas securities statutes and Texas statutory and common law.<sup>35</sup> The district court granted the defendants summary judgment on the fraud claims, but permitted James' case to go to the jury on his contract claim. James introduced parol evidence to show that Nico had agreed to allow him to participate in all wells on the 711 non-flood-plain acres, and the jury awarded him a substantial recovery for Nico's breach of contract.<sup>36</sup>

The court of appeals set aside the verdict on the breach of contract because the cover letter did not identify the land under option with sufficient specificity to satisfy the statute of frauds.<sup>37</sup> The court affirmed the summary judgment on the state law fraud claims because James had not presented any evidence of misrepresentation in response to the defendant's motion.<sup>38</sup> The court took a different approach in affirming the summary judgment on the rule 10b-5 claim, however, concluding that James could not prove compensable injury.<sup>39</sup> According to the court, "[o]bviously, to say that James suffered an injury in the security transaction cannot be taken seriously."<sup>40</sup>

The courts have not clearly articulated how damages are to be determined in cases brought under rule 10b-5 or what relief suc-

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32. *Id.*

33. *Id.*

34. *Id.* at 1367-68.

35. *Id.* at 1368.

36. *Id.*

37. *Id.* at 1368-69.

38. *Id.* at 1372.

39. *Id.* at 1371.

40. *Id.*



cessful plaintiffs are due.<sup>41</sup> A wide variety of misconduct in a wide variety of circumstances has been successfully challenged under the rule, and perhaps no simple statement can encompass the injuries the rule addresses or the relief it affords. Nonetheless, the case of a deceived buyer who makes money presents a novel setting for considering injury and remedy. An examination of the way the court used the measure of damages it deemed appropriate in this setting may show that there are indeed reasons to allow some defrauded investors to recover more than their out-of-pocket damages.

In *James*, the court started its discussion of injury by stating that the typical defrauded buyer recovering under rule 10b-5 is entitled to out-of-pocket damages, that is, "the difference between the market price of the stock and the price that the plaintiffs paid."<sup>42</sup> *James* argued that instead of out-of-pocket damages, he was entitled to a share of the profits in all the wells drilled on the 711 nonflood-plain acres. *James* relied on *Affiliated Ute Citizens v. United States*,<sup>43</sup> in which the Supreme Court allowed defrauded sellers to recover the profits their buyers' made on resale. Although it recognized that *Affiliated Ute* can be read to entitle defrauded investors to their malefactors' profits, the court of appeals chose to treat it as only a special application of the out-of-pocket rule under which defrauded sellers may look to future developments in measuring the value of the stock they sell.<sup>44</sup> As for *James*, the

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41. See generally 4 A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* §§ 9.1-.3 (1979); D. DOBBS, *REMEDIES* 614-18 (1973); T. HAZEN, *THE LAW OF SECURITIES REGULATION* 470 (1985); 5C A. JACOBS, *LITIGATION AND PRACTICE UNDER RULE 10b-5* §§ 259-265 (1988); L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 965-75 (2d ed. 1988); M. STEINBERG, *SECURITIES REGULATION: LIABILITIES AND REMEDIES* § 7.06 (1988); Crane, *An Analysis of Causation Under Rule 10b-5*, 9 SEC. REG. L.J. 99 (1981); Easterbrook & Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611 (1985); Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suiting the Remedy to the Wrong*, 66 TEX. L. REV. 469 (1988); Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349 (1984); Note, *Rule 10b-5 Damage Computation: Application of Financial Theory to Determine Net Economic Loss*, 51 FORDHAM L. REV. 838 (1983); Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STAN. L. REV. 371 (1974).

42. 838 F.2d at 1371.

43. 406 U.S. 128 (1972).

44. 838 F.2d at 1371. *James* did not involve fraud on a seller, so the court did not develop its interpretation of *Affiliated Ute*. At one point, it said that the fraudulent buyer's resale price "may be deemed the market value . . . for the purposes of calculating the out-of-pocket injury." *Id.* If this is so, then a defrauded seller will be entitled to all of her buyer's profit, even that due to factors entirely unrelated to the fraud, including, for example, appreciation attributable to a market-wide increase in security prices. However, the

court concluded that even if future developments were to be considered in his case, his security was worth far more than he paid for it. Accordingly, he had no "injury even under the calculation rationale of disgorgement."<sup>45</sup> The court found "no reason in equity or policy or precedent to apply any rule that is an exception to the traditional out-of-pocket measure of damages."<sup>46</sup>

The court insisted that its conclusion that James suffered no compensable injury was compelled by "controlling precedent of the Fifth Circuit requiring the application of the out-of-pocket rule in the case before us."<sup>47</sup> James suffered no injury, the court reasoned, because under settled law there could be no recovery. The Fifth Circuit has consistently held that a defrauded buyer is entitled to recover the difference between the price she paid for a security and the value of what she received, with what she received being valued as of the time of the transaction. Assuming, as the court did, that James proved all the elements of a rule 10b-5 case other than injury, the case came down to comparing the value of what James bought with what he paid for it.

The price James paid would not have been hard to determine,<sup>48</sup> but the value of what he received would have been. The court apparently concluded that determining the value of what James bought was not necessary since he ultimately made a profit. In equating initial value with subsequent return, the court ignored the fact that when James bought the security he accepted a substantial risk that he would not make any profit at all. It was inappropriate to ignore that risk—in fact, that risk was the heart of the security. James' investment carried with it the possibility of a spectacular return, but when he invested no one could know what the return would be. That uncertainty explains Nico's willingness to take \$317,000 for an interest that eventually paid \$1,866,000 and James' willingness to pay \$317,000 for an interest that might have paid nothing.

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court may not have meant this because it went on to say that for the purpose of the out-of-pocket rule, the value of a defrauded seller's securities are "measured at a reasonable time after the sale, i.e., after the concealed information has been disclosed to the general public and the stock reflects its true value." *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

48. Although James made several separate investment decisions, the court lumped all his investments together and netted them against his total return from all the wells to determine he had not been injured by any fraud in connection with his option.

What was the value of James' interest when he bought it if it was not the \$1,866,000 he eventually received as owner? It may be impossible to say. Determining the value of a security is seldom a simple task, and it would not have been a simple task in *James*. Measuring the value of tangible assets is hard enough, and measuring the value of securities is even harder. Presumably, many negotiated trades occur precisely because the buyer and the seller disagree on value.

When a security is traded somewhat regularly, market prices may supply satisfactory evidence of value. Value may mean nothing more than the price at which fully informed buyers and sellers are willing to trade.<sup>49</sup> In reasonably well-developed markets, traders respond quickly to the revelation of new information. All other things being equal, the value of a security as to which a misrepresentation has been made is its market price after the fraud is discovered and the truth made known. Of course, developments in the issuer and the market that have nothing to do with the fraud may cause the market price of the security to change during the period the fraud remains undetected. However, the price at which the security would have traded but for the fraud can at least be estimated by factoring out the effects of intervening events.

*James* expresses the out-of-pocket measure as "the difference between the market price of the stock and the price that the plaintiffs paid,"<sup>50</sup> but as far as appears in the opinion, there never was a market for interests in the Nico wells. The court simply treated subsequent issuer distributions as the equivalent of subsequent market price. If James' security had been traded in a market, disclosure of the oil find probably would have pushed its price above what James paid. But such a market reaction would not have shown whether, when James bought the security, it was worth what he paid for it. If Nico's deception had been revealed before the oil find and the security's market price had fallen below the purchase price, James would presumably be said to have suffered an out-of-pocket loss equal to the decline. That out-of-pocket loss would not be recalculated if market price jumped dramatically upon subsequent disclosure of the oil find.<sup>51</sup>

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49. Market prices may be taken to reflect intrinsic value, or they may themselves be the only value that matters.

50. 838 F.2d at 1371.

51. Similarly, if the oil find was disclosed first and disclosure of the deception depressed the market price, but left it above what James paid, it might well be said that

The security James bought can usefully be compared to a lottery ticket.<sup>52</sup> A lottery ticket that gives its holder a right to participate in drawings for several prizes including a top prize of a million dollars is not worth a million dollars. Instead, it is worth what that right is worth. If the value of that right is the price at which willing buyers and sellers will trade it, and if tickets sell for a dollar, then any particular ticket is worth a dollar. A ticket will be worth a million dollars when and if it turns out to be the grand prize winner, but certainly in an important sense the winning ticket is not worth a million dollars the day before the drawing. The day before the drawing it is worth a dollar.<sup>53</sup> A junior ticket that entitles the holder to participate in all the drawings except that for the grand prize is worth less than a regular ticket. If the junior ticket wins a thousand dollars it will be worth a thousand dollars, but before the drawing it is not worth a thousand dollars and is in fact worth less than a regular one dollar ticket.

*James* is important not because the court reached a wrong conclusion about the value of what James bought, but because the court did not try to reach a conclusion. The opinion begins and ends emphasizing that James was complaining about a deal on

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James had suffered an out-of-pocket loss, notwithstanding his net profit on the investment. Perhaps he would be entitled to recover a part of his purchase price proportional to the decline in the security's market price occasioned by revelation of the fraud.

It may be helpful to consider the case that would have been presented had the Nico leases proved dry. The hypothetical James might be entitled to rescind the deal and get his money back on account of Nico's misrepresentations, but he would not recover any out-of-pocket damages. See *In re Letterman Bros. Energy Sec. Litig.*, 799 F.2d 967, 973 (5th Cir. 1986) ("Leases that permit the exploration and exploitation of mineral resources are of considerable value."), *cert. denied*, 480 U.S. 918 (1987). Because the failure of the investment did not relate to the misrepresented facts, and the risk of failure was fully and honestly disclosed, his loss was not proximately caused by Nico's misrepresentations. See *Huddleston v. Herman & MacLean*, 640 F.2d at 549-50, 555. Yet the approach suggested in *James* would allow the hypothetical James to recover his entire purchase price, based on the reasoning that inasmuch as the security turned out to be worthless, it was worthless when it was sold.

If James would not have been permitted to recover actual losses not proximately caused by the misrepresentation, then his dishonest seller should not be permitted to avoid liability because James realized a profit, unless the profit somehow reveals that the misrepresentation caused James no harm. The fact that James did profit on his investment does not show that Nico's misrepresentations did not cause him any harm. If Nico had told the truth or had been telling the truth, James' profit would have been even more dramatic.

52. The analogy to a lottery ticket is not perfect because careful analysis of the well site could have produced significant insights into its value. Nevertheless, in the end no one can be sure what either a well or a ticket will produce. Perhaps a bet on a horse race would be a better analogy.

53. Conversely, if the ticket turns out to be a loser, it was still worth a dollar when it was purchased.

which he made a substantial profit, and the case may come to mean that a defrauded buyer who sells at a profit or otherwise receives a return in excess of her total investment cannot recover under rule 10b-5.<sup>54</sup> James' problem was that, inasmuch as he made money on the deal, it is not readily apparent that he should recover anything, even if what he got was worth less than what he paid for it.

The out-of-pocket measure of damages used in rule 10b-5 cases in the Fifth Circuit is appropriate if the purpose of the remedy is to make sure that defrauded buyers get their money's worth. Buyers who make bad deals are not normally entitled to go to court to get their money's worth. Thus, identifying what it is about fraud that entitles defrauded buyers to be treated differently is important.<sup>55</sup> The unusual facts of *James* show that misrepresentations do more than leave the deceived party with something worth less than what she paid for it. A wrong of fraud is that the victim does not get that for which she pays. Fraud is wrong even if what the victim does get is worth the price.

Victims of fraud rightly complain when they rely on misrepresentations to their detriment. The consequence of a victim's reliance is the measure of her injury. Victims rely on misrepresentations by making deals they would not otherwise make. In doing so, they may part with money or valuable goods or services, but they may also pass up alternative deals. If James relied on Nico's misrepresentations, he relied by buying this security instead of another. If he was to be compensated for that reliance, he should have been given the value of the security he would have bought. James probably could not have identified the particular security he would have bought but for Nico's misrepresentations. However, the value of what Nico falsely told him he was buying is an appropriate measure of the value of what James passed up and, likewise, of what he should be entitled to recover. Nico presumably did not

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54. Fifth Circuit cases permitting recovery of consequential damages, such as *James v. Meinke*, 778 F.2d 200 (5th Cir. 1985), which *James v. Nico* cites for the basic rule, 838 F.2d at 1371, suggest that purchase price is not a ceiling on rule 10b-5 recovery. See also *Wolf v. Frank*, 477 F.2d 467 (5th Cir.), cert. denied, 414 U.S. 975 (1973).

55. If a seller knowingly misleads a buyer, the buyer may be permitted to rescind the transaction regardless of her injury. However, defrauded buyers are entitled to rescind and get restitution, not because they deserve compensation, but because telling lies is bad and liars should not retain the fruits of their wrongful acts. Because James did not want to rescind the transaction, the court appropriately considered how the misrepresentation injured him.

make any more of a misrepresentation than it thought was necessary to get James to buy.<sup>56</sup> Courts generally have recognized as much, and the benefit of the bargain is the measure of recovery usually afforded for fraud, and in analogous actions, for breach of warranty.

Awarding defrauded buyers like James the benefit of their bargains might also further the public policies usually identified with the federal securities statutes.<sup>57</sup> If the courts do not protect reliance by awarding the benefit of the bargain in cases in which it is the best measure of reliance, then investors will have to protect themselves. They can do so by investigating the truth of the representations made to them before investing. Denying compensatory damages may sometimes be appropriate to encourage investors to investigate. For example, perhaps investors injured by relying on negligent misrepresentations should be denied any recovery if they could have discovered the truth by exercising minimal prudence. Allowing recovery in such cases might force issuers to waste money checking the accuracy of representations that investors could check much more cheaply. Investigation is costly, though, and sellers of securities must compensate buyers for the investigations they feel they must make. Inasmuch as the cost of capital to security issuers reflects the cost of these investigations, the law should not encourage investor investigation unless in so doing it furthers a legitimate interest of issuers or others.<sup>58</sup> No one has a legitimate reason knowingly to misrepresent the terms of a security for the purpose of inducing someone to buy it, and investors should not be given the burden of investigating deliberate lies of the sort James apparently alleged he was told.<sup>59</sup>

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56. The perpetrator of a fraud is not liable under rule 10b-5 unless she acted with scienter, and, perhaps, it would be neither unjust nor unwise to forbid perpetrators even to try to prove they lied more than was necessary.

57. Easterbrook & Fischel, *supra* note 41, develop the thesis that sanctions for securities fraud should encourage conduct consistent with the ends of the securities laws.

58. The sanctions available under the securities laws may affect the cost and allocation of capital even if investors ignore the availability of judicial remedies in deciding how much investigation to undertake. No matter what remedy investors are eventually given, their capital may be wasted if they rely on misrepresentations. The threat of substantial sanctions may prevent misrepresentations from being made in the first place.

59. James' rule 10b-5 claim is not set out in the opinion. The court said it assumed James could prove "a material misrepresentation or omission, scienter and reliance," but in its discussion of his state law fraud claims it emphasized that he had failed to present any evidence of any misrepresentation. 838 F.2d at 1370. If James' claim was simply that Nico failed to tell him it would drill its own wells in the nonflood-plain area, what Nico did wrong is not clear. Deceit is as much an element of a rule 10b-5 violation as it is an element of

The court "could find no reason in equity or policy" to allow James to recover more than "the traditional out-of-pocket measure of damages."<sup>60</sup> Nevertheless, the courts might better compensate victims and reduce the cost of raising capital by measuring damages in terms of the bargain in appropriate circumstances.<sup>61</sup> Courts usually limit victims to recovery of out-of-pocket damages,<sup>62</sup> and of course there are often good reasons for this recovery. For example, it may be impossible to determine what the security would have been worth if the seller's representations had been true. However, warranty damages are not always difficult to prove, and out-of-pocket loss is not always certain. In *James*, for instance, determining the value of what Nico promised would probably have been much easier than determining the value of what James bought at the time he bought it. In the end, each wrong should determine its own remedy. All wrongs may not merit the same remedy.

### CARELESS PLAINTIFFS

The success of a fraud case often depends on the way the victim responds when she learns she has been defrauded or when information that might alert her to the fraud becomes available to her. Victims who fail to act or who act inappropriately may be barred from recovering because of laches, waiver, ratification, want of due care, or the statute of limitations. The conduct of plaintiffs

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fraud. If Nico did not misrepresent anything, it could not have deceived James unless it had an affirmative obligation to disclose its drilling plans, which does not seem to have been the case.

60. *Id.* at 1371.

61. The usual objections to awarding a warranty measure of damages are most compelling when the fraud relates to a publicly traded security. See generally Easterbrook & Fischel, *supra* note 41. The market often discounts misrepresentations of material fact, in which case investors who rely on misrepresentations pay the appropriate price for a security and do not in fact suffer any out-of-pocket loss. If the market is fooled, out-of-pocket loss—for instance, the decline in market price occasioned by revelation of the fraud—may be the appropriate measure of injury. Recovery of more than out-of-pocket loss is deserved only to the extent the plaintiff gave up some unusually profitable opportunity in reliance on the misrepresentation. However, the market does not often offer unusually profitable opportunities. When a misrepresentation is made during the course of face-to-face negotiations over a security deal, it is perhaps appropriate to assume that the misrepresentation would not have been made unless the victim in fact had attractive alternative investments. See *supra* notes 24-26 and accompanying text. However, this assumption is not justified when misrepresentation is made to the public at large, especially when it is made by a person who is not even selling securities. See, e.g., *Basic Inc. v. Levinson*, 108 S. Ct. 978.

62. Sections 11 and 12 of the Securities Act, 15 U.S.C. §§ 77k, 77l (1982), provide for rescissionary relief. Cf. 15 U.S.C. § 78bb(a) (1982) (no recovery under Exchange Act in excess of actual damages).

was the determinative consideration in several of the securities cases the Fifth Circuit decided during the survey period.

In *Stephenson v. Paine Webber Jackson & Curtis, Inc.*,<sup>63</sup> the court reaffirmed that rule 10b-5 plaintiffs must prove that they have pursued their own interests with care and good faith.<sup>64</sup> The plaintiff in that case, Monroe Stephenson, sued his brokerage firm and his account executive for effecting sixty-seven securities transactions for his account without his authorization.<sup>65</sup> Between August 1982 and August 1983 Stephenson had received confirmations and monthly statements reflecting all of the trades, but he testified that he regarded this material as junk mail and he admitted he never opened most of it.<sup>66</sup> Stephenson testified that he complained to his account executive about one unauthorized trade in October 1982 and another in June 1983, but he first complained in writing in August 1983, and then only to his account executive and only about a relatively small number of trades.<sup>67</sup> Stephenson finally wrote the firm in September 1983, at which time he identified fifty-nine transactions he claimed were unauthorized.<sup>68</sup> Stephenson brought suit in May 1984, complaining that the unauthorized trading violated several laws, including rule 10b-5. He attempted to prove that the firm had supervised his account executive inadequately and that the firm would have learned of the unauthorized trading earlier if it had supervised properly.<sup>69</sup>

The district court dismissed the rule 10b-5 claim at the close of Stephenson's case, and Stephenson appealed.<sup>70</sup> The court of appeals affirmed because Stephenson failed to prove that he had exercised due diligence to protect his own interest.<sup>71</sup> As part of his case, Stephenson had to prove he was not reckless.<sup>72</sup> The district

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63. 839 F.2d 1095 (5th Cir.), *cert. denied*, 109 S. Ct. 310 (1988).

64. *But cf.* *MBank-Fort Worth, N.A. v. Trans Meridian, Inc.*, 820 F.2d 716, 725 (5th Cir. 1987) (plaintiff does not have burden of proving due diligence under Texas Blue Sky Law).

65. 839 F.2d at 1096.

66. *Id.* at 1097.

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.* The district court also found that the claim was barred by laches, waiver, and ratification. The court of appeals did not consider the plaintiff's challenges to these findings because it affirmed the dismissal on the basis of the plaintiff's recklessness. *Id.* at 1100 n.13.

72. *Id.* at 1098. "[T]he relevant inquiry is whether the plaintiff has 'intentionally refused to investigate "in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would



court found that he had been reckless in failing to read his account statements and in failing to notify the firm promptly of the problems he did discover. The court of appeals agreed, citing Stephenson's "high level of education, experience, and demonstrated prowess in financial and securities matters" as critical factors in its decision.<sup>73</sup>

Before the Fifth Circuit, Stephenson argued that his conduct was irrelevant.<sup>74</sup> He contended that, notwithstanding settled Fifth Circuit law,<sup>75</sup> rule 10b-5 plaintiffs should not be required to prove their due diligence, and defendants should not be able to escape liability on the basis of various affirmative defenses based on plaintiffs' unreasonable conduct.<sup>76</sup> Stephenson argued that the requirement that plaintiffs prove due diligence and affirmative defenses based on a plaintiff's failure to pursue his interests diligently could not survive the Supreme Court's decision in *Bateman Eichler, Hill Richards, Inc. v. Berner*.<sup>77</sup>

The plaintiffs in *Bateman Eichler* alleged that an employee of the defendant brokerage firm induced them to buy securities by telling them that insiders had told him the issuer had valuable rights in African gold mines.<sup>78</sup> They sued after the price of the securities fell, but the district court dismissed their complaint for failure to state a claim under rule 10b-5. The court held that since the plaintiffs violated rule 10b-5 themselves by trading on nonpublic information, the doctrine of *in pari delicto* barred recovery.<sup>79</sup>

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follow." " *Id.* (quoting *Dupuy v. Dupuy*, 551 F.2d 1005, 1020 (5th Cir.) (quoting in turn *W. PROSSER, LAW OF TORTS* § 34, at 185 (4th ed. 1971)), *cert. denied*, 434 U.S. 911 (1977)).

73. *Id.* at 1100; *see also id.* at 1097 n.6. The court explained that Stephenson was competent to have reviewed his account "statements, as most people do their monthly bank statements, and discern a pattern of error." *Id.* at 1100.

74. Inasmuch as the finding of recklessness was one of fact not to be set aside unless clearly erroneous, the court's affirmation is not surprising. Indeed, it was not clear to the court that Stephenson even challenged the finding. *Id.* at 1099.

75. The Fifth Circuit thoroughly re-examined the relevance of a plaintiff's want of care in a rule 10b-5 case in *Dupuy v. Dupuy*, 551 F.2d at 1020. The re-examination was prompted by *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), in which the Supreme Court held that a plaintiff has to prove more than the defendant's negligence to establish scienter under rule 10b-5. *Dupuy* reaffirmed that only plaintiffs who have used due diligence to take care of their own interests can recover under the rule. Plaintiffs need prove only that they were not reckless, but they have the burden of proving at least this level of care. 551 F.2d at 1020. The court has consistently looked to *Dupuy* when faced with the contention that a plaintiff's want of care should bar recovery. *See* 839 F.2d at 1098 n.9.

76. 839 F.2d at 1098.

77. 472 U.S. 299 (1985).

78. *Id.* at 301-02.

79. *Id.* at 304.

The Supreme Court disagreed and held that

a private action for damages in these circumstances may be barred on the grounds of the plaintiff's own culpability only where (1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public.<sup>80</sup>

Stephenson argued that "*Bateman Eichler* essentially abolished the due diligence requirement for private 10b-5 actions."<sup>81</sup> However, he was unable to convince the court of appeals that requiring plaintiffs to prove they were not reckless undercuts the policies of the federal securities laws.<sup>82</sup> The court explained that *Bateman Eichler* was the result of the Supreme Court's "concern that insider trading may go largely undiscovered by law enforcement officials if tippees are *altogether precluded* by *in pari delicto* from bringing suit against tippers."<sup>83</sup> It reasoned that the due diligence requirement and equitable defenses like waiver, laches, estoppel, and ratification "ultimately foster the same law enforcement goal as *Bateman Eichler*, but from a different perspective."<sup>84</sup> According to the Fifth Circuit, a court appropriately denies recovery to an investor who has not been attentive to self-protection, at least when the plaintiff has not participated in any securities law violations.<sup>85</sup>

Stephenson draws valid and important distinctions between doctrines based on want of care and the doctrine of *in pari delicto*. One can conclude, as the court apparently did, that "requiring plaintiffs to invest carefully" will discourage fraud,<sup>86</sup> and an anti-fraud scheme could logically permit plaintiffs who have partici-

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80. *Id.* at 310-11.

81. 839 F.2d at 1098 (citing *Bateman Eichler*, 472 U.S. 299).

82. The court did not set out Stephenson's argument, but said only that it was an "analogy, founded on general references to the deterrent aspects of the federal securities laws." *Id.* at 1099. See generally Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96, 129-37 (1985).

83. 839 F.2d at 1099 (emphasis in original).

84. *Id.*

85. *Id.* The court "acknowledge[d] that . . . it might be logically inconsistent" to bar recovery by a tippee on grounds of waiver, estoppel, or ratification. *Id.* at n.10.

86. *Id.* at 1099 (quoting *Dupuy*, 551 F.2d at 1014). Similarly, the best way to keep account executives from unauthorized trading may be to require investors like Stephenson to supervise them.

pated in a fraud to sue their confederates while denying any remedy to those who fail to take care of themselves. Nonetheless, distinctions may not be enough to distinguish *Bateman Eichler*.

The rules that will best serve the public in the end may not be the ones that will lead to effective enforcement of the securities laws. For example, courts might best protect the public by applying the rule of *caveat emptor*, but to do so would hardly lead to effective enforcement of the provisions of the securities laws that proscribe false statements.<sup>87</sup> In *Bateman Eichler*, the Court seemed to be concerned at least as much with the enforcement of the securities laws as with the accomplishment of their ends.<sup>88</sup> The court said as much in *Stephenson*,<sup>89</sup> but it failed to consider the effect of its decision on the enforcement of rule 10b-5. Be that as it may, *Stephenson* will probably influence other courts when they reconsider the doctrine of due diligence in the light of *Bateman Eichler* and *Pinter v. Dahl*,<sup>90</sup> the Supreme Court's latest foray into *in pari delicto*.

The court also considered the relevance of a victim's failure to discover fraud or failure to respond quickly and effectively upon discovery of fraud in several cases in which the statute of limitations was pleaded as a defense.<sup>91</sup> *Davis v. A.G. Edwards & Sons, Inc.*,<sup>92</sup> is one such case. *Davis* does not establish any new securities law, but it underscores the importance of careful pleading.

Dr. Davis and his son complained that their account executive and his firm were liable to them for churning their accounts.<sup>93</sup> The court borrowed Louisiana's two-year statute of limitations and applied it to the Davises' rule 10b-5 claims.<sup>94</sup> Under federal law, the two years began to run when the plaintiffs had knowledge of the facts forming the basis of their action.<sup>95</sup> The Davises brought their

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87. Cf. *Bateman Eichler*, 472 U.S. at 315.

88. See Sachs, *supra* note 82, at 132-33.

89. "Thus, *Bateman Eichler* specifically limits its holding regarding the inapplicability of the *in pari delicto* defense to situations where preclusion of suit would interfere with the enforcement of the securities laws." 839 F.2d at 1099 (citing *Bateman Eichler*, 472 U.S. 299).

90. 108 S. Ct. 2063 (1988).

91. In addition to the cases discussed below, see *Jensen v. Snellings*, 841 F.2d 600 (5th Cir. 1988). In *Jensen*, the court affirmed a summary judgment dismissing a rule 10b-5 claim as time barred.

92. 823 F.2d 105 (5th Cir. 1987).

93. *Id.* at 107.

94. *Id.*

95. *Id.* In *Jensen v. Snellings*, the court suggested that defendants have the burden of

actions more than two years after they closed their accounts, but they argued that they did not know of any problems when they closed their accounts and became suspicious only later when Dr. Davis discovered that their account executive had lied to him about a transaction.<sup>96</sup> Unfortunately, the Davises alleged in their complaints that they closed the accounts "as a result of Defendants' excessive and objectionable trading practices."<sup>97</sup> Although Dr. Davis stated in an affidavit that he did not suspect any of the defendants of wrongdoing until he discovered the lie, the court treated the allegations of the complaints as the plaintiffs' admissions that they knew the basic facts more than two years before they commenced their actions. Inasmuch as the admissions were contained in the pleadings, they were conclusively binding on the plaintiffs.<sup>98</sup>

*Romano v. Merrill Lynch, Pierce, Fenner & Smith*<sup>99</sup> dealt primarily with alleged abuses in connection with a commodities futures trading account,<sup>100</sup> but the *Stephenson* court suggested that *Romano* is precedent for securities cases;<sup>101</sup> its treatment of limitations in churning cases is interesting. *Romano* suggests that receipt of a trade confirmation or account statement starts the running of the statute of limitations, at least as to the confirmed or accounted transactions,<sup>102</sup> unless the investor can show that the information

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proving that plaintiffs should have discovered fraud so as to start the limitations period. "To prevail on their affirmative defense of prescription, the defendants had to show that more than two years prior to bringing suit under § 10(b) and Rule 10b-5, the plaintiffs had knowledge sufficient to begin the running of the limitations period." 841 F.2d at 606. The court did not say who has the burden of proving notice or knowledge in the other cases in which it discussed the matter. See generally 5C A. JACOBS, *supra* note 41, § 235.03, at 10-43 to -55.

96. 823 F.2d at 107.

97. *Id.*

98. *Id.* at 108.

99. 834 F.2d 523 (5th Cir. 1987).

100. The plaintiff claimed that he was entitled to recover under rule 10b-5 because the defendants placed his deposit for his commodities account into a money market account without his authorization. *Id.* at 526. The court of appeals noted that it was undisputed that transactions in the money market account were "technically securities transactions," *id.* at n.4, but it affirmed summary judgment for the defendants on the rule 10b-5 claim because the plaintiff could not identify any loss resulting from having idle funds placed in an income-producing account. *Id.* at 528. The court affirmed the dismissal of a related RICO claim because there was no predicate securities fraud inasmuch as there was no rule 10b-5 violation. *Id.* at 526-27.

101. *Stephenson*, 839 F.2d at 1100 n.14.

102. The district court held that the statute of limitations barred the churning cause of action only to the extent that it was based on trades prior to March 1983. 834 F.2d at 528. The court of appeals did not consider the propriety of parsing a churning claim, but perhaps

included in the statements was insufficient to provide notice of the claim.

The plaintiff in *Romano* sued his brokerage firm and several of its affiliates, complaining among other things of churning of his commodities account.<sup>103</sup> The defendants moved for summary judgment on the basis of the statute of limitations, and the district court granted the motion as to that part of the churning claim based on trades occurring more than two years before the suit was filed.<sup>104</sup> The plaintiff appealed, and the Commodity Futures Trading Commission (CFTC) filed a brief as amicus curiae in which it urged the court of appeals to disapprove what it took to be the the district court's holding—that as a matter of law the statute of limitations for a churning claim begins to run upon a customer's receipt of monthly account statements.<sup>105</sup>

The court of appeals started from the proposition that the statute of limitations did not begin to run until the plaintiff had knowledge of the churning or notice of facts that should have led him to that knowledge.<sup>106</sup> The dispositive question was whether the plaintiff had notice. The record contained no evidence that the plaintiff lacked notice. To the contrary, the court found substantial evidence of notice in that the plaintiff regularly received confirmations of his trades and received monthly statements reflecting all

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notice sufficient to bar an action as to part of a churning violation should bar the entire action. The essence of a churning claim is not that particular trades are inappropriate, but rather that the account has been traded excessively. As the court said in *Romano*, churning is a unified offense. *Id.* (quoting *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 327 (5th Cir. 1981)). Once a customer is aware of facts that would put her on notice of a pattern of excessive trading, she presumably has notice of the whole violation. It is arguable that once the limitations period begins to run, it should run for the whole offense, even if the offense continues. *Cf. D. DOBBS, supra* note 41, at 336-37 (permanent nuisance).

103. 834 F.2d at 525.

104. *Id.* at 528. Thereafter the court dismissed the churning claim to the extent it was not barred by limitations because the plaintiff failed to prove his case. The court of appeals affirmed this dismissal. *Id.* at 529. The court looked to securities cases to define the offense of churning, and its brief discussion may serve as precedent for securities cases. Among other things, a churning plaintiff must show that the defendant broker exercised control over trading in the account. The court observed that the defendants made recommendations to *Romano*, but found that *Romano* exercised control. "The investment decisions were his; the account was nondiscretionary." *Id.* If the court intended to say that only discretionary accounts can be churned illegally, its holding would be novel. *See* 2 A. BROMBERG & L. LOWENFELS, *supra* note 41, § 5.7(321), at 5:82.95-.102; N. WOLFSON, R. PHILLIPS & T. RUSSO, *REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS* § 2.11 (1977 & Supp. 1988).

105. 834 F.2d at 529 n.12.

106. *Id.* at 528.

transactions involving his account.<sup>107</sup>

The court emphasized that the question of notice is one of fact.<sup>108</sup> It stated that receipt of statements and confirmations does not constitute notice as a matter of law because a record of trades does not in itself show that trading was excessive.<sup>109</sup> However, the court considered the district court's decision and concluded it was correct based on the undisputed evidence.<sup>110</sup> The defendants had apprised the plaintiff of trading activity in his account by means of account statements and other correspondence. The court held that the defendants were entitled to summary judgment on the basis of evidence that the plaintiff had notice of the activity in his account because the plaintiff had not produced any evidence tending to show he was ignorant of his claim or confused about it.<sup>111</sup>

Assuming that account statements contain information which,

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107. *Id.* at 528-29.

108. The court re-emphasized that the question of notice is one of fact in *Corwin v. Marney, Orton Investments*, 843 F.2d 194 (5th Cir. 1988). This was the second appeal of a case in which the plaintiffs complained, among other things, that the offering materials they had received before buying interests in a limited partnership failed to reveal a promoter's interest in an entity doing business with the partnership. *Id.* at 196. The first appeal was from an order dismissing the plaintiffs' rule 10b-5 claim on the basis of its being barred by the statute of limitations. *Id.* at 195. The court treated the order as one granting summary judgment and reversed. The action was barred if the plaintiffs knew or should have known of the violations two years before filing suit. *Corwin v. Marney, Orton Investments*, 788 F.2d 1063, 1066 (5th Cir. 1986). Although the action was brought more than two years after the plaintiffs invested, in response to the motion to dismiss, they "alleged and supported their contentions" that they sued within a few months of learning of the fraud. *Id.* at 1069. Summary judgment was inappropriate on the issue of notice because it was not immediately clear when the investors should have discovered the fraud, and the defendants had not identified "communications or occurrences which would have alerted the suspicions of a reasonably diligent investor." *Id.* at 1069.

Following remand, the defendants showed that public records on file with the State of Texas disclosed the promoter's interest in the related entity. The district court granted the defendants summary judgment, holding that the plaintiffs should have discovered the fraud the month they invested. Once again the court of appeals reversed and remanded for a trial. 843 F.2d at 195. The defendants argued that because state law often imputes constructive knowledge of the contents of public records, as a matter of law the plaintiffs should have known of the information in the records. The court held that regardless of state law notice rules, it would not hold as a matter of law that reasonably diligent investors examine all available public records. *Id.* at 198. Accordingly, the finder of fact should have been given the question of when the plaintiffs should have known of the fraud so as to start the running of the limitations period.

109. 834 F.2d at 528. *But cf. Stephenson*, 839 F.2d at 1099 n.14 (citing authority that mere receipt of confirmation slips does not provide sufficient notice of churning; however, the court refrained from ruling on the issue).

110. 834 F.2d at 529.

111. *Id.*

upon analysis, would reveal churning,<sup>112</sup> the question of notice will usually turn on the investor's ability to perform the analysis.<sup>113</sup> Despite the court's insistence that it was dealing only with the record before it, *Romano* suggests that at the very least the investor who has received accurate account statements has the burden of putting that ability in issue.<sup>114</sup> The court clearly held that a brokerage firm that informed its customer of the activity in her account is entitled to summary judgment on the question of notice if the customer cannot respond with more than her unsupported assertion that she was not aware of the violation.<sup>115</sup>

### BROKER-DEALERS AND CUSTOMERS

An important function of securities law is the regulation of the market itself. Many of the institutions that regularly operate in the market or provide important support services are regulated in almost every facet of their operations. Although the statutes and regulations consist largely of detailed rules for specialized market participants, most litigated cases are decided under a few provisions that govern the conduct of everyone who participates in the securities markets. Thus, although regulated brokers or dealers were defendants in almost all of the cases discussed above, the cases were decided under principles of general applicability. Nonetheless, perhaps the most important developments of the year were in the area of market regulation.

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112. Presumably, defendants are not entitled to prevail on the notice issue if the statements do not contain enough information to reveal the violation. In its brief, the CFTC argued that churning "cannot be readily detected from account statements." Brief of Amicus Curiae at 7, *Romano v. Merrill Lynch, Pierce, Fenner & Smith*, 834 F.2d 523 (5th Cir. 1987) (No. 87-3069) [hereinafter Brief].

113. The court's emphasis on the plaintiff's sophistication suggests that the question is whether the plaintiff should have discovered the violation, not whether a reasonable investor would have. *But see Jensen*, 841 F.2d at 608 ("The standard for whether facts sufficient to commence the limitations period would have been discovered upon reasonable inquiry is an objective one."); *cf. Corwin v. Marney, Orton Invs.*, 788 F.2d at 1069 (court should consider "communications or occurrences which would have alerted the suspicions of a reasonably diligent investor").

114. The CFTC criticized the district court for apparently failing to consider whether the "plaintiff even had in his possession information from which an experienced investor could find evidence of churning." Brief, *supra* note 112, at 11. The court of appeals apparently assumed that the information in the account statements was sufficient to allow an investor as sophisticated as the plaintiff to discover the fraud. The court may have determined that the defendants had demonstrated sufficiency in the district court, or it may have intended to hold that accurate account statements are presumed sufficient unless the plaintiff puts their sufficiency into issue.

115. 834 F.2d at 529.

The October panic brought issues of market regulation to center stage. Although it is too early to know whether this attention will produce substantial changes in the law, during the survey year there were several important developments in the law regulating the relationship between brokerage firms and their customers. Early in the year, the Supreme Court held in *Shearson/American Express v. McMahon*<sup>116</sup> that agreements to arbitrate Exchange Act<sup>117</sup> claims are enforceable in accordance with the provisions of the Federal Arbitration Act.<sup>118</sup> Thereafter, the Fifth Circuit dealt with the retroactive application of the Supreme Court's decision and discussed the possibility that brokerage firms may sometimes be obliged to explain to their customers how they compensate their sales personnel.

In *Noble v. Drexel, Burnham, Lambert, Inc.*,<sup>119</sup> the Fifth Circuit held that *McMahon* would govern pending cases, although the court suggested that it might be inappropriate to order arbitration in cases that had already gone to trial when *McMahon* was decided. *Noble* appears to be the first case to discuss the question of the retroactive application of *McMahon*, and its careful analysis is likely to guide other courts. The court started from the proposition that cases are decided under the law existing when they are decided, and then asked whether the plaintiff, who wanted to avoid arbitration, was entitled to an exception.<sup>120</sup> The court answered this question within the framework of *Chevron Oil Co. v. Huson*,<sup>121</sup> in which the Supreme Court identified three factors it had considered in deciding whether to apply a new decision to events that took place before the decision was announced: first, whether the decision established a new principle of law; second, whether retroactive application of the new rule would further or retard its purpose and operation; and third, whether retroactive application would be inequitable.

Considering the first factor, the court in *Noble* found that while *McMahon* overturned Fifth Circuit precedent, the change

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116. 107 S. Ct. 2332 (1987).

117. Securities Exchange Act of 1934, ch. 404, title I, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78kk (1982 & Supp. IV 1986)).

118. Act approved July 30, 1947, ch. 392, § 1, 61 Stat. 669 (codified as amended at 9 U.S.C. §§ 1-14 (1982)).

119. 823 F.2d 849 (5th Cir. 1987); see also *King v. Drexel, Burnham, Lambert, Inc.*, 825 F.2d 68 (5th Cir. 1987).

120. 823 F.2d at 850.

121. 404 U.S. 97, 106-07 (1971).



had been foreshadowed in "an unswerving line of Supreme Court cases expanding the reach of arbitration agreements."<sup>122</sup> The court found that the second factor suggested retroactivity, inasmuch as there is a strong federal policy in favor of arbitration and no policy favoring securities litigation.<sup>123</sup> Finally, the court saw no injustice in requiring litigants to arbitrate, at least in cases that had not yet gone to trial.<sup>124</sup> Given that its *Chevron* analysis did not on balance suggest that retroactive application of *McMahon* is inappropriate, the court concluded that it should follow the usual rule that federal cases are decided in accordance with the law as it exists at the time of decision.<sup>125</sup>

The court dealt with another post-*McMahon* issue in *Villa Garcia v. Merrill Lynch, Pierce, Fenner and Smith Inc.*<sup>126</sup> The defendants in that case moved the district court to compel the plaintiff to arbitrate his section 10(b) claims, which were based on his allegations that the defendants made numerous unauthorized trades in his account.<sup>127</sup> The plaintiff opposed the motion, arguing among other things that the arbitration agreement was voidable because the brokerage-firm defendant had violated SEC rule 15c2-2<sup>128</sup> by entering into the agreement.<sup>129</sup> The district court denied the motion to compel arbitration without recording its reasons, and the defendants appealed.

With certain exceptions, rule 15c2-2 declared it a fraudulent, manipulative, or deceptive device for a broker or dealer to enter into or have in effect an agreement purporting to bind a public customer to arbitrate future disputes between them arising under the federal securities laws.<sup>130</sup> The SEC rescinded the rule after the *McMahon* decision and while the *Villa Garcia* appeal was pending, and the Fifth Circuit held that the rescission should be applied

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122. 823 F.2d at 850.

123. *Id.*

124. *Id.* The court would not consider the argument that customers might have signed arbitration agreements only in reliance on precedent holding such agreements unenforceable. "[W]e simply could not accept any claim that [the customer] would not have entered into these non-negotiable pre-printed agreements had he realized that 1934 Act claims would turn out to be arbitrable." *Id.* at 851. The court's reaction may foreshadow hostility to challenges to arbitration agreements grounded in general contract law defenses.

125. *Id.*

126. 833 F.2d 545 (5th Cir. 1987).

127. *Id.* at 546.

128. 17 C.F.R. § 15c2-2 (1987).

129. 833 F.2d at 546.

130. 17 C.F.R. § 15c2-2.

retroactively.<sup>131</sup>

Even if customers cannot raise violations of rule 15c2-2 as defenses to motions to compel arbitration, the rule may have a lasting impact. While the rule was in effect it forbade brokers and dealers to use customer agreements calling for arbitration of disputes under the federal securities laws. Even if the rule was invalid, the contracts drafted in compliance with it are still contracts, and presumably, most contracts entered into while the rule was in effect exclude disputes governed by the Exchange Act from arbitration. Thus, the Merrill Lynch agreement at issue in *Villa Garcia* provided that controversies arising out of it would be arbitrated "[e]xcept to the extent that controversies involving claims arising under the Federal securities laws may be litigated."<sup>132</sup> The court of appeals recognized that this language may have excepted the plaintiff's claim from arbitration, but since the district court had not explained itself and the case had to be remanded anyway, the court did not resolve the issue.<sup>133</sup>

The court dealt with the substantive law governing the relationship between a securities firm and its customers in *Shivangi v. Dean Witter Reynolds, Inc.*<sup>134</sup> The case presented the issue of whether brokerage firms are required to tell their customers how they compensate their sales personnel. The district court held that under certain circumstances they must, concluding that a salesman "recommending a stock must disclose if he will gain financially from the sale above and beyond normal compensation."<sup>135</sup> The court of appeals avoided the question, but in doing so it may have simply clouded the issue.

The plaintiffs in *Shivangi* bought 400 shares of an over-the-counter stock on the advice of their account executive at Dean Witter.<sup>136</sup> Dean Witter made a market in the stock, and it sold the plaintiffs the stock rather than acquiring the stock from a third party on behalf of its customer. Dean Witter could have acquired the stock as agent for the plaintiffs, but its policy was to handle

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131. 833 F.2d at 547. The defendants did not challenge the plaintiff's right to raise the firm's violation of the rule as a defense. *Id.* at 546.

132. *Id.*

133. *Id.*

134. 825 F.2d 885 (5th Cir. 1987).

135. *Shivangi v. Dean Witter Reynolds, Inc.*, 107 F.R.D. 313, 318 (S.D. Miss. 1985) (denying defendant's motion for summary judgment); cf. *Shivangi v. Dean Witter Reynolds, Inc.*, 637 F. Supp. 1001, 1003 (S.D. Miss. 1986).

136. 825 F.2d at 887.

customer transactions in stocks in which it made a market as principal unless the customer asked it to act as agent.<sup>137</sup> Dean Witter computed the price it charged the plaintiffs by adding a mark-up to the lowest price any market maker asked for the stock. The mark-up was less than the commission Dean Witter would have charged for acquiring the stock as the plaintiffs' agent, and, thus, the plaintiffs paid less for the stock than they would have had Dean Witter acted as their agent.<sup>138</sup>

When Dean Witter sold a customer an over-the-counter stock as principal, it paid the account executive responsible for the trade a portion of the mark-up plus a portion of the spread between the bid price and the asked price. Although Dean Witter's pricing policy always resulted in customers paying less for securities in principal transactions than they would have in agency transactions, Dean Witter's compensation policy sometimes resulted in account executives receiving substantially more for principal transactions than they would for agency transactions when customers bought over-the-counter securities in which Dean Witter made a market.<sup>139</sup> Thus, the plaintiffs' account executive received \$400 for the trade, as against a commission of between \$46.41 and \$61.88 he would have received had Dean Witter acted as the plaintiffs' agent. When Dean Witter confirmed the sale, it notified the plaintiffs that it sold as principal and that it was a market maker in the stock, but no one told the plaintiffs anything about how their account executive was compensated until after they filed suit.<sup>140</sup>

After a brief rise, the market price of the stock declined steadily, and the plaintiffs sold within a year at a substantial loss. They then sued their account executive and Dean Witter, and in an amended complaint alleged that the defendants' failure to disclose "that Dean Witter offered a credit or bounty to brokers who sold stocks in which Dean Witter made a market" violated rule 10b-5 and state law.<sup>141</sup> The district court denied the defendants' motion for summary judgment on the issue of whether Dean Witter was required to disclose the amount of compensation it paid its ac-

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137. *Id.*

138. *Id.*

139. *Id.* Account representatives were not paid a portion of the spread when their clients sold, so they received about the same compensation in agency and principal trades when clients sold over-the-counter stocks in which Dean Witter made a market. 107 F.R.D. at 317.

140. 825 F.2d at 887-88.

141. 107 F.R.D. at 315 n.1.

count executives. The court concluded that "[t]he extra compensation received by Dean Witter account executives in principal trades in which Dean Witter makes a market, over and above the compensation normally received in agency trades, creates a potential conflict of interest which is a material fact which ought by law be disclosed to investors."<sup>142</sup> Nonetheless, the court dismissed the complaint at the end of the plaintiffs' case because the plaintiffs did not prove that the defendants acted with scienter when they failed to disclose the premium compensation.<sup>143</sup>

The court of appeals affirmed the dismissal on the ground that the district court's finding that the the plaintiffs had failed to prove scienter was not clearly erroneous.<sup>144</sup> The plaintiffs did not complain of misrepresentations, but rather of wrongful silence. Thus, the court had to deal with the rather tricky question of scienter in an omission case. The plaintiffs had to prove "that Dean Witter acted with actual 'intent to deceive, manipulate, or defraud,' or severe recklessness."<sup>145</sup> In the case of misrepresentation, the speaker's knowledge that she is lying can demonstrate an intent to deceive. In the case of wrongful omission, the question of intent apparently turns on what the defendant who should have spoken can be charged with knowing about her victim. The plaintiffs argued that Dean Witter knowingly and recklessly failed to disclose the compensation system, but this was not enough according to the court because "knowledge of omitted facts does not itself establish scienter."<sup>146</sup> The district court did not clearly err in finding "that the defendants did not know nor should have known the danger of misleading the customers by the omission."<sup>147</sup> No evidence was presented to indicate that the defendants actually intended to deceive the plaintiffs by failing to disclose the compensation system; Dean Witter had complied with the SEC's confirmation rule<sup>148</sup> and "any danger of misleading the customers by the omission was not obvious."<sup>149</sup>

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142. *Id.* at 318.

143. *Id.* at 325.

144. 825 F.2d at 889.

145. *Id.* (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. at 193 n.12).

146. *Id.*

147. *Id.*

148. 17 C.F.R. § 240.10b-10 (1987). The rule was amended since the date of the trade.

149. 825 F.2d at 889. The plaintiffs also argued that the district court's finding on scienter was wrong because they had proved manipulative intent in that the compensation system was designed to give account executives an incentive to stimulate demand for the stock toward the end of manipulating the market. The court of appeals rejected this argu-

The pivotal fact in *Shivagni* was that none of the defendants said anything about how the account executive was compensated. Rule 10b-5 speaks in terms of fraud and deception, and given that the defendants were silent on the subject of compensation, they did not violate the rule unless they were under a duty to disclose compensation or if some statement they made was rendered misleading by virtue of their silence. The district court faced the question squarely and found that Dean Witter was required to disclose.<sup>150</sup> Dean Witter and the Securities Industry Association, which participated as amicus curiae, thought the question important and argued that the firm had no duty to disclose. However, the court of appeals seemed consciously to avoid discussing or even raising the question of whether Dean Witter had any obligation to disclose how it compensated account executives in the first place.

Dean Witter cross appealed and asked the court to vacate or reverse the district court's finding that account executive compensation was a material fact that should have been disclosed. The

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ment as well. The Fifth Circuit cited the Supreme Court's decision in *Hochfelder*, 425 U.S. at 199, for the proposition that, as used in section 10(b), the word "manipulative" is virtually a term of art that refers to arcane practices intended to mislead investors. *Id.* Although it suggested that manipulation is only a form of deception, in the end the court did not define the word; it simply held that to prove that the compensation system was a manipulative device, the plaintiffs had to show more than that it gave the account executive an incentive to sell the stock. *Id.* at 889-90.

The court did not need to decide whether the plaintiffs showed manipulative intent by showing that the compensation system encouraged the account executive to sell the stock. Rule 10b-5 does not forbid manipulative practices; by its terms it forbids false statements and fraud. 17 C.F.R. § 240.10b-5 (1988). The court did not suggest that a negligent misrepresentation would be actionable under rule 10b-5 if made with manipulative intent, whatever that is. Thus, the plaintiffs would not have saved their rule 10b-5 case by proving that Dean Witter's conduct and intent were manipulative within the meaning of section 10(b). The court's treatment of manipulation is nonetheless important. If compensation systems are not manipulative devices, then the SEC has no power to regulate them under section 10(b) nor, presumably, under the other provisions of the Exchange Act that call upon it to regulate manipulative practices. The SEC may not have this power, but the court had no reason to discuss the meaning of manipulation in *Shivagni* or the cases it relied upon.

150. The two reported opinions of the district court suggest that a brokerage firm has a duty to disclose unusual compensation arrangements to its customers and that it was necessary to disclose the premium compensation for principal transactions to keep the recommendation from being misleading.

It is generally agreed that firms owe their customers some loyalty and care; the court did not belabor the matter or even cite authority in *Romano* when it held that a commodities broker owes its clients a fiduciary duty. 834 F.2d at 530. The Securities Industry Association admitted in its brief as amicus curiae that Dean Witter was obligated to disclose some information to the plaintiffs; it just denied that Dean Witter had to disclose information about compensation. Brief of Amicus Curiae, *Shivangi v. Dean Witter Reynolds, Inc.*, 825 F.2d 885 (5th Cir. 1987) (No. 86-4370).

court did not review the finding

because the district court's findings on materiality are not final: the district court made the statements in denying a motion for summary judgment . . . and in dicta after granting the motion to dismiss for failure to prove scienter. In any event, the district court's comments were made before defendants' proof, and doubtlessly lack preclusive effect.<sup>151</sup>

In avoiding the issue that troubled Dean Witter, the court of appeals may have highlighted it. In any case, the approach the court took to the case suggests some important questions.

The court did not say what scienter is in an omission case, but its analysis suggests that the critical question is whether the defendants should have known that the plaintiffs would have been surprised to learn of the omitted fact. The court emphasized that the plaintiffs failed to show either that other firms disclosed how they compensated their sales personnel or that Dean Witter's compensation system affected the price or value of the stock.<sup>152</sup> However, in intimating that such a showing would have changed the outcome of the case, the court suggested that those in the securities business may be required to disclose whatever is important.

It would be a mistake to impose a general duty to disclose material information, even if the statutes could be read to support it. Leaving aside the effect such a duty would have on the discovery and the dissemination of information, it would place a tremendous burden on those subject to it. The only way to protect relatively blameless nondisclosers would be to hold the information they failed to disclose immaterial. The court did something like this in *Shivangi*, emphasizing that "the materiality of [compensation] information remains an open question today" and characterizing the district court's finding that the information should have been disclosed as a finding on materiality.<sup>153</sup> Yet, if compensation information is immaterial, then brokers and dealers may lie about it. Surely, such a lie would be a serious wrong and a violation of several provisions of the securities laws, including rule 10b-5.

The compensation system was material in the sense that a reasonable investor would consider it important in deciding whether to buy the stock that had been recommended to her; as the court

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151. 825 F.2d at 892 (citations omitted).

152. *Id.* at 889.

153. *Id.*

seemed to recognize, by basing compensation in part on the spread between bid and ask price, Dean Witter gave its account executives an incentive to recommend thinly traded stocks in which it made a market.<sup>154</sup> Even if the account executive recommended the stock because Dean Witter's best analyst considered it a good investment,<sup>155</sup> the plaintiffs might have discounted his recommendation had they known that he would realize more from their purchase of this stock than he would from their purchase of alternative investments.<sup>156</sup>

If the result in *Shivangi* is correct, it is not because an account executive's compensation on a given trade is immaterial to her clients. Rather, the result is correct because Dean Witter had no obligation to volunteer compensation information to the plaintiffs. The regulatory authorities do not require brokerage firms to disclose how they compensate sales personnel, and presumably most investors know that not all products produce the same profits for their brokers. This does not mean that compensation plans are immaterial. It just means that brokers need not disclose compensation, and it relies on the fact that most investors are prepared to trade in ignorance of it. Simply put, the federal securities statutes and the rules promulgated under them do not require the disclosure of all material information.

### CONCLUSION

It may be appropriate to try to characterize the court's approach to securities law over the past year, but there may not be any unifying themes or trends at work in the Fifth Circuit's securities cases.<sup>157</sup> Perhaps neither individual judges nor the court as a whole consider enough securities cases to develop what can in any important sense be called an approach to securities law. None of the judges decided many securities cases during the survey year, and the only judge to author more than one signed opinion was a

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154. *Id.* at 887 n.3, 889-90; see also *supra* notes 131-39 and accompanying text; cf. 107 F.R.D. at 316 ("Dean Witter aggressively markets the stocks in which it is a market maker . . .").

155. 825 F.2d at 889.

156. The district court emphasized this even after granting the defendants' motion to dismiss. 637 F. Supp. at 1005.

157. The court did permit district courts to dispose of complaints before considering the merits in a substantial portion of the securities cases it considered.

district judge sitting by designation.<sup>158</sup>

The subject matter of the cases the court was called upon to consider may be more revealing than the way the court dealt with those cases. The court had almost no occasion to consider the registration provisions of the Securities Act<sup>159</sup> or the complex regulatory structure that governs the securities markets. Instead, the court's securities docket was dominated by fraud cases brought under rule 10b-5. So far as appears in the cases decided by the Fifth Circuit last year, the rule has at last completely eclipsed the statutes.<sup>160</sup>

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158. *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356 (5th Cir. 1987) (Feldman, J.), *cert. denied*, 108 S. Ct. 1220 (1988); *Romano v. Merrill Lynch, Pierce, Fenner & Smith*, 834 F.2d 523 (5th Cir. 1987) (Feldman, J.).

159. *But see United States v. Corn*, 836 F.2d 889 (5th Cir. 1988) (appeal from a conviction for criminal contempt for violating injunction against violations of the registration provisions of the Securities Act).

160. Any survey of securities law would be incomplete and misleading if it failed to mention the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-1968 (1982 & Supp. IV 1986). Plaintiffs alleged RICO violations in almost all the securities cases the Fifth Circuit considered last year, including *Corwin*, *Davis*, *James*, *Jensen*, *MBank*, *Romano*, *Shivangi*, and *Stephenson*. See generally Wood, *Fifth Circuit Survey: Civil RICO*, 19 TEX. TECH L. REV. 463 (1988) (survey of Fifth Circuit opinions for year ending June 30, 1987).



